

The Importance of Cash Flow Analysis for Small Businesses

By Stan Scott

Why accrual-based accounting is just the beginning for small businesses.

Asset-based lenders must accurately gauge a borrower's credit risk profile based upon its inherent value chain, life cycle stage and external environment, including economic and industry trends. Small business lenders cannot analyze borrowers in a vacuum and can gain the information they need online. To measure a prospective borrower, lenders must understand the demand/supply dynamics of the prospect's industry as they affect cost structure, volume, pricing, distribution channels and capacity.

Financial results are a key measure of management's success in formulating a business model and executing a strategy. In theory, small businesses succeed because they can anticipate and mitigate threats, capitalize on opportunities and engineer timely solutions. Practically speaking, small business entrepreneurs spend more time reacting to events. Due to size and resource constraints, they wield little control over their external environment; therefore, they are more vulnerable to adverse changes within it.

A firm's success is measured by its capacity to generate sufficient cash flow from operations to pay its obligations, enhance its credit rating and maximize shareholder value. To evaluate small business creditworthiness, a pinpointed cash flow analysis is critical, in part to compensate for deficiencies of accrual-based accounting.

Economic and Industry Analysis

Loan officers must understand industry and economic trends to avoid borrowers competing in a decline-stage or high-obsolescence risk industry,

borrowers subject to systematic displacement by foreign competition or untimely loans to borrowers in highly cyclical industries. Personal consumption is the engine that drives the \$13 trillion U.S. economy, representing 70 percent of total gross domestic product (GDP). Personal consumption is centered in services (59 percent), such as housing; nondurable goods (29 percent), such as food; and durable goods (12 percent), such as furniture. Gross private domestic investment represents approximately 17 percent of GDP, of which business spending on high-tech equipment and software (38 percent) ranks first followed by commercial real estate and industrial and transportation equipment spending. The U.S. economy is primarily service based, representing 68 percent of GDP. The manufacturing sector represents 20 percent.

These factors have driven a shift in loan volume toward the service sector. In 2005, real GDP rose 3.2 percent on the strength of a 3.5-percent boost in personal consumption supported evenly by durable and nondurable growth. Business spending recorded a 6.1-percent gain following an 11.9-percent surge the prior year with double-digit growth in transportation equipment and computer equipment and software.

A key question with regard to product/service class is whether it caters to a basic, enduring need or a recreational want or luxury and is supported by a stable market infrastructure. If the prospective borrower is making or selling a product, is it a consumer or capital good, that is, does it depend on consumer or business spending? If a consumer

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product, is it durable or nondurable? If nondurable, is it perishable or nonperishable? In an expansionary cycle, growth in consumer spending precedes business spending. The capital goods sector is prone to cyclical swings and was particularly hard-hit during the last recession.

For commodities such as oil, smaller companies often struggle to pass on price fluctuations. This is a key risk factor. Are they subject to foreign competition? Do they compete in a growth, mature or decline-stage industry? Growth industries are often characterized by favorable economic characteristics, thus lowering barriers to entry and allowing more small businesses to participate. Businesses in growth industries enjoy greater margin cushion and wield greater capacity to implement favorable price changes to enhance margins or pass on cost increases. Mature industries are often characterized by high barriers to entry, ongoing consolidation and intense margin pressure. In mature industries, small competitors may be held captive by shifting market forces.

Example: Economic and Industry Trends Affecting the Furniture Industry

According to the Small Business Association (SBA), in 2002 the U.S. domestic universe of furniture and related firms consisted of 21,194 manufacturers, 13,017 wholesalers and 49,846 retailers. To put things in perspective, the top domestic furniture participant is a \$2.4 billion a year company.

Exhibit 1 shows the different performance of manufacturers, wholesalers and retailers within a single industry. Performance variances show the importance of using the borrower's industry value chain as a frame of reference for comparing prospective borrowers.

Distinguishing factors by business type include the following:

- Capital intensity: Highest for manufacturers
- Labor intensity: Manufacturers are more labor intensive as a percentage of sales; wholesalers report higher average wages per employee; retailers employ the greatest number of workers.
- Working capital intensity: Highest for wholesalers
- Sales trend: Strongest for retailers, weakest for manufacturers
- Margin pressure: Greatest for manufacturers

Among small businesses, because manufacturers are more labor and capital intensive, they naturally bear a higher degree of operating leverage. This imposes greater risk due to higher overhead and greater debt-service requirements in support of fixed assets, which raises break-even sales point. Once manufacturers exceed break-even, however, economies of scale take over and increase financial rewards. The wholesaler is working capital intensive, serving as an intermediary for buyers and sellers while assuming product storage costs and inventory carrying risk.

For the furniture industry, major risk factors include the following:

- Fierce price competition
- Declining sales growth trends
- Changing furniture styles or fashion risk
- Declining housing market
- Rising price of lumber
- Threat of foreign imports
- Rising interest rates
- Rising oil prices

The rapid growth in imports—up threefold the last 10 years—has resulted in declining volume and compressed margins for manufacturers. In 2005, furniture and household equipment sales increased 9.5 percent to \$373 billion, or three percent of GDP, up 3.5 percent during the same period.

Exhibit 1. Overview of the Furniture Industry

Furniture NAICS#	Total Firms	Peer Firms	Total Sales	Peer Sales	Total Employees	Average Payroll	Sales/Employee
Manufacturers 337122	3,985	120	\$11,708	\$2,681	110,045	\$689M	\$106M
Wholesale 423220	5,939	488	\$31,827	\$8,739	64,675	\$457M	\$492M
Retail 442110	21,464	531	\$52,533	\$9,060	262,634	\$344M	\$200M

Note: SBA 2002 firm size data by NAICS code (\$million).

Exhibit 2. Goals and Risks at Different Stages of the Business Life Cycle

	Growth Stage (Average 16 years)	Mature/Early Decline Stage (Average 37 years)
Marketing objectives	<ul style="list-style-type: none"> Define niche; distinguish competitive edge; leverage low barriers to entry; develop favorable reputation; cultivate recurring sales base; reach critical mass via rapid organic growth (10+ % /year) Leverage industry demand-pull growth and price elasticity 	<ul style="list-style-type: none"> Leverage proven reputation; retain customer loyalty; achieve modest (< 5%) organic growth; adapt niche in accordance with changing market dynamics Grow via acquisition; penetrate new market; capitalize on competitor failure; shift to higher-margin products
Risk factors	<ul style="list-style-type: none"> Uncontrolled growth beyond capacity to manage/deliver Excessive credit risk; unhealthy concentration Inadequate market penetration; lack of market focus, undefined niche; poor pricing strategy Industry or economic recession Demand for competing related products 	<ul style="list-style-type: none"> Complacency making the business out of touch with market; price inelasticity; high barriers to entry in new markets Excessive credit risk; unhealthy concentration Loss of key marketing personnel Product obsolescence; industry or economic recession; escalating foreign competition Intense price competition; industry consolidation; monopolistic trade practices
Production objectives	<ul style="list-style-type: none"> Achieve economies of scale; develop buying proficiency; expand capacity; increase productivity 	<ul style="list-style-type: none"> Minimize costs; cut capacity; downsize; reduce staff; upgrade machinery and equipment
Risk factors	<ul style="list-style-type: none"> Inefficient production or delivery system; quality issues; inadequate capacity resulting in costly outsourcing Underdeveloped supply chain channel; skilled labor shortage 	<ul style="list-style-type: none"> Overexpansion; excess capacity and labor; obsolete machinery and equipment, poor maintenance Margin compression; rising labor costs
Financial objectives	<ul style="list-style-type: none"> Leverage assets: secure working capital, obtain fixed-asset financing support Cultivate satisfactory supplier relations and terms Achieve efficient trade cycle management 	<ul style="list-style-type: none"> Maintain efficient trade cycle management and favorable vendor relations Refinance working capital and machinery and equipment debt on more favorable terms Upgrade information technology and accounting systems
Risk factors	<ul style="list-style-type: none"> Undercapitalization High interest costs and debt-service requirement Tight/strained liquidity, poor cash flow and vendor relations due to heavy working capital requirements, losses, poor trade cycle management Rising interest rates; supply chain limitations; credit tightening 	<ul style="list-style-type: none"> Heavy debt burden due to overexpansion High leverage due to inadequate earnings retention Strained liquidity and cash flow and stretched trade due to losses, poor trade cycle management Lengthening trade cycle and slower pay practices; rising interest rates; credit tightening

It is also critical to distinguish among key risk factors in each industry segment. For example, in the oil and gas industry, wholesalers operate on thin margins and are bound to contractual price change limitations, so they face high commodity price risk. Service providers to production and exploration companies have flourished in recent years due to global oil and gas dependency and continued supply/demand imbalances.

Life Cycle Analysis

Life cycle analysis is not always self-evident, as stage evolution may be indiscernible—clear only in hindsight. Nor does it follow a standard path or duration. Management may reinvent a company many times during its history. A systematic life cycle analysis in small business lending is relevant, since applicants at various stages share common characteristics, for example, financial distress, high leverage or a major change in the business model. Regardless of stage, whether infancy, growth, mature or decline, companies commonly experience transitional conditions within these rather loosely defined stages (Exhibit 2).

The prevailing issue to consider in evaluating a growth-stage entity is whether or not it can manage its growth. Does it possess the capacity, resources and assets to manage the growth satisfactorily? For mature-stage companies, the overriding issue is whether or not they have slipped into complacency or early decline. If so, are they capable of successful reorganization? Is the industry in decline?

During the current economic expansion, small business asset-based lenders have seen more growth refinancing opportunities. Acquisitions that involved growth and mature stage companies alike, as well as loans to cyclical manufacturers, have also been prevalent. There has been limited turnaround activity. The acquisition opportunities are fueled by the heavy influx of equity participants willing to invest in the higher-risk private sector in hopes of earning high returns on proven performers or turning around foundering businesses. A key long-term viability issue for the cyclical manufacturers is their capacity to sustain themselves during the next downturn.

Financial Analysis

Small business asset-based lenders often budget inadequate time to investigate the triggers that

stimulate financial change. They rely instead on conservative advance rates, strong collateral coverage, cash control, credit enhancements and, perhaps, balance-sheet strength as a collective hedge against financial risk. Some tend to focus analytical efforts predominately on earnings or earnings before interest, taxes, depreciation and amortization (EBITDA). The shortcomings of these measures are well documented. Small business accounting deficiencies stemming from the prevalence of unaudited financial statements make this approach problematic, since earnings and asset quality may be questionable. Revenue recognition and matching, inventory valuation methods, accruals, asset depreciation/amortization, recognition of bad debt or obsolete inventory and use of estimates all can skew financial accounting results. While EBITDA should not be ignored, a careful cash flow analysis may mitigate some of the weaknesses of accrual-based accounting. In addition, cash flow analysis focuses analytical efforts on the cash flow drivers, thus addressing the major triggers to changes in financial results. Since the cash flow statement serves to translate accrual-based results into cash basis accounting, a focus on the underpinnings should reveal the symptoms-triggers-causes/effects-solutions of financial performance.

Net cash flow change is a function of sales activity, operating leverage and net trade cycle duration fluctuation. Long-term sales success hinges on capitalizing on favorable industry/economic conditions. Operating leverage and net trade cycle duration are determined by cost structure and fixed and working capital intensity. Cost structure is a function of the relationship between embedded fixed versus variable costs. An increase in sales generally requires an incremental investment in operating costs and working capital, creating an inverse relationship between earnings and cash flow during the growth and decline stages. The required level of incremental investment in operating costs is a function of operating leverage and decreases as economies of scale are achieved. Economies of scale result in an increase in gross margin percentage and corresponding decrease in operating expense margin (OEM) percentage, thus, higher earnings on both a constant and common-size basis. All else constant, higher earnings do not translate to a like amount of incremental cash flow, since earnings are offset by growth in net trading assets.

A picture of critical cash flow drivers should emerge from reviewing the intrinsic value chain, peer group, industry, economic environment and life cycle stage. It is important to distinguish between turnover or common-size change as compared to growth or sequential change and then to differentiate between internal and external causes. Leaving all else constant, a change in sales results in changes in gross margin, net operating profit, accounts receivable, inventory and accounts payable. It is important to consider which drivers are most significant, either as a source or as a use of cash, and also to examine the impact of net trade cycle change. For wholesalers, which need high levels of working capital yet have a highly elastic cost structure, change in trading assets and change in trade cycle have significant effects. For capital-intensive manufacturers, changes in sales and gross profit margin percentages have significant effects.

How does the borrower's cash flow driver performance stack up against industry and peer group results? Negative variances may represent opportunities for improvement. Slow sales in relation to

industry and target market may reflect poorly on management. Subpar gross margins or excessive operating expenses may suggest poor pricing or low productivity. How does productivity (sales/labor) compare to the industry? Is slow turning accounts receivable a reflection of industry trends or poor collection efforts? Rising inventories can signal either greater confidence in future demand or an unexpected drop in sales.

Summary

Economic expansion, low default rates and high liquidity are driving lenders to compete aggressively. Competitive pressure is breeding narrower margins and easy credit. But rapid loan growth at the expense of credit quality is generally a recipe for disaster. Aggressive lenders slow to purge risk-laden portfolios may pay in loan losses, while prudent lenders may be able to capitalize on countercyclical opportunities. That's why it is so important to practice prudent fundamental underwriting and portfolio management principles.

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